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# Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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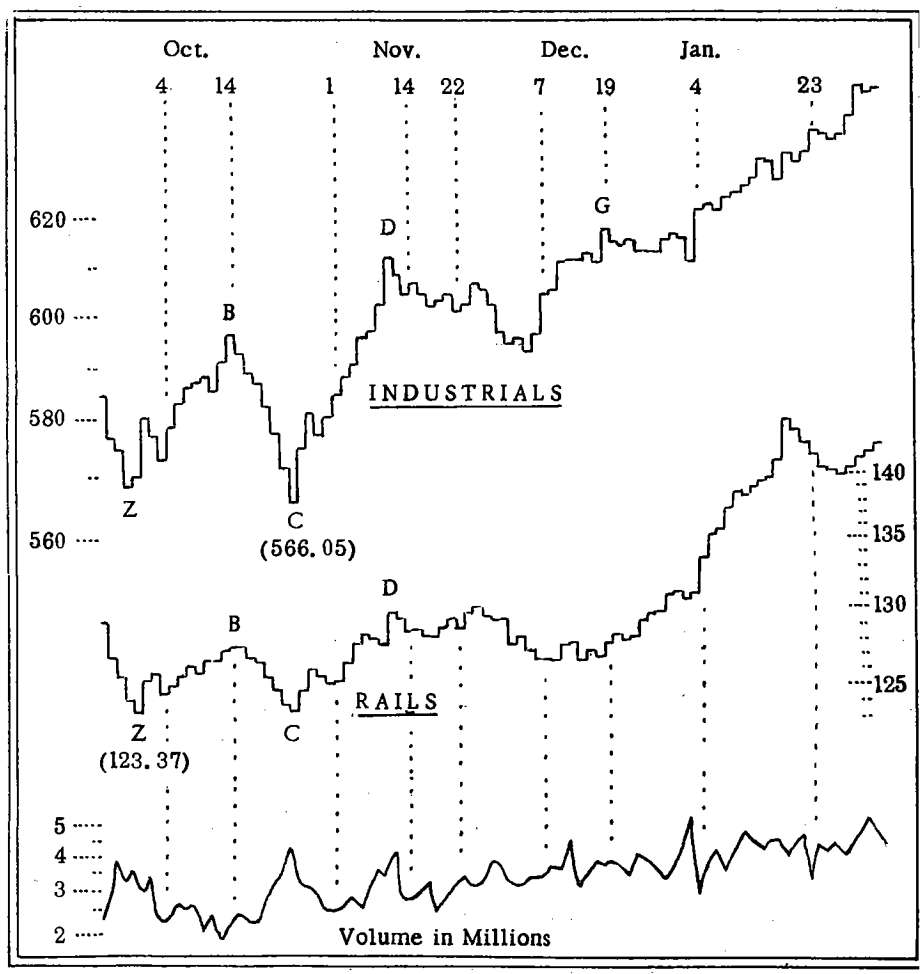
CURRENT MARKET A number of days and even weeks before the January 30 "State of the Union" message, rumors circulated among New York's more "sophisticated" circles to the effect that Kennedy would be a "fiscal conservative, perhaps even more conservative than Nixon would have been". But the Market (as is usually the case) was able to separate the gossip from the facts, and it is now obvious that at least part of the recent rise was in anticipation of President Kennedy's announced determination to inject "vigor" into the economy via the spending route. As the Wall Street Journal put it (January 31 editorial),

> "You would be hard pressed to find any category for which the Government might possibly spend money that was not included in the catalogue. We do not know how Congress will react to these spending promises, but if even a fraction of them are added to the Eisenhower budget, they will not only unbalance it but topple it over entirely."

Seldom has opinion been so divided as to the future course of the stock market and the economy, and the current huge volume of transactions attests to this division. It is interesting to note that volume in January (28 million shares) was the heaviest of any January since 1929. Moreover, on January 30 and 31, the total number of issues traded on the Exchange touched historic highs of 1301 and 1303. This even more than volume suggests the unusual participation at this time. Another measurement is worth examining. Normally the number of issues whose price remains unchanged during a trading session totals about 240. But recently there have been a number of days during which the unchanged list dropped to 200-215. This implies that many positions which are usually left undisturbed have now been activated. In other words, in recent sessions almost everything on the "Board" has "come out" for its share of trading, and the greater the volume, the more issues traded and the fewer "unchanged" issues, the more unusual (or abnormal) the participation.



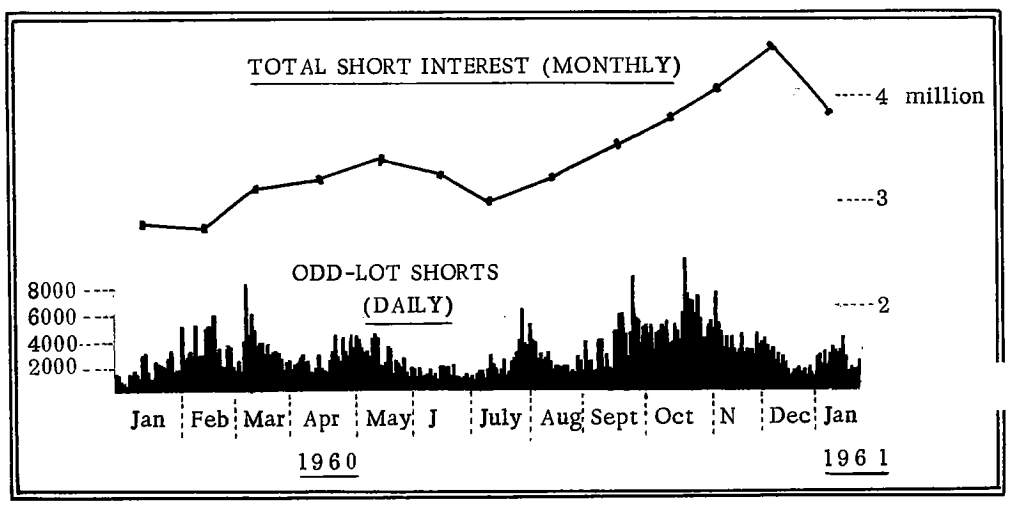

In the last Letter reference was made to the true secondary peaks of 146.56 for Rails (March 10, 1960) and 656.42 for Industrials (June 9, 1960). These now stand as the major points of resistance to a further advance. The March Rail peak in particular has stood as a barrier to every advance of the last ten months. In June, 1960, the upward thrust came to a halt as Rails stopped at 146.01. On August 24 another rally petered out with Rails halting at 140.81. On the most recent advance Rails touched a high of 144.89 (Janu-

ary 18), but they subsequently retreated, and as of this writing are still below the 144.89 peak.

From the standpoint of Dow's Theory the 656.42 and 146.56 points now assume a particular significance. A bettering of those levels by both Averages would open the way to an attack on the 1959-60 highs, while a persistent refusal of one or both Averages to penetrate those highs would constitute the first sign of impending danger.

SHORTS A great deal of interest seems to have been stirred up by the short interest ratio study in Letter 131. A number of subscribers have written to say that it is a simple matter to keep a running average of daily volume over a given period; but, they ask, is there any way of estimating whether the total short interest is rising or declining? I have done quite a bit of experimental work on this question, and the chart below may open a new avenue of research.

This chart shows the total monthly short interest figures superimposed upon the actual daily odd-lot short totals. I have found that there is a definite relationship between daily odd-lot totals (published daily in the Wall Street Journal, weekly in Barron's) and the direction of the total short interest. A persistent trend in odd-lot shorting will often coincide with (but more often lead) the total monthly short interest figures.



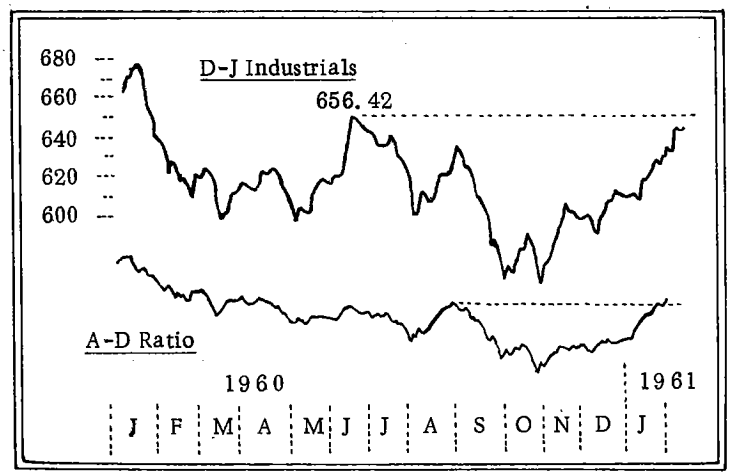

Note that from January through March, 1960, odd-lot shorting tended to increase. Subsequently in February the total short interest began climbing. In May, June and early July odd-lot shorting was low, and this was followed by a decline in the total short interest during June and July. In late July there was a spurt of odd-lot shorting, a slight lull (August), and then another extended period of heavy odd-lot shorting lasting from September through October. This entire period from July to October coincided with a five month increase in the total short interest which touched a high of 4.4 million in December, 1960.

Odd-lot shorting peaked in October, then steadily diminished to the normal seasonal low of late December. This suggested that the total short interest build-up was at least temporarily over. The January, 1961 short interest figures verified this, and the short position dropped sharply from 4.4 to 3.7 million shares. Thus the contraction in odd-lot shorting preceded the first drop in the total short interest by two to three months. Latest odd-lot short statistics suggest that the total short interest is holding steady or (more probably) still declining.

BREADTH (A-D RATIO) Periodically I comment on the implications of market "breadth" (the Advance-Decline Ratio). The breadth was last discussed in Letter 122; at that time it was stated that it is necessary for the D-J Industrials and the A-D Ratio to confirm each other, and that such confirmation is an important market consideration (Letter 122 described the construction of the A-D Ratio, and extra copies are available to subscribers please send self-addressed stamped envelope).

On the chart we see that in August, 1960, the A-D Ratio bettered its own June high, but this penetration was not confirmed by Industrials. This technical non-confirmation gave way to the August-October sell-off. Since October, 1960, however, the A-D Ratio has climbed steadily higher, and on January 30 it succeeded in bettering the breadth peak

established last August. This means that market breadth has now risen above the levels of both August and June, 1960. Technically it is now up to Industrials to confirm the breadth by bettering their own June high. If Industrials can better the secondary high of June, 1960 (656.42) the next objective would be the all-time high of 685.47 recorded in January, 1960.




In the last Letter ("VACUUMS") I noted that the ideal market is one in which breadth, Industrials and Rails all move "in gear". From a technical standpoint, then, we will be watching to see whether (1) Industrials can confirm breadth by bettering their June high of 656.42, and (2) Rails can also confirm by bettering their own March secondary high of 146.56. If both Averages can confirm we will have received the strongest possible technical signal. Conversely, a failure of the Averages to confirm breadth should give rise to the first important decline since the bear market lows.

PATIENCE Eight or ten years ago one of the reasons advanced for buying common stocks was that "they provide a good income". In the early 1950's many seasoned investment-grade stocks were, in fact, selling to yield 6, 7 and 8%. I can remember combing brokers' lists of utilities in the early '50's and selecting specific issues on the basis of yield and geographical location. Utilities in Southern or Western states where the population was growing generally provided yields of around 5 to 6% while utilities in less dynamic areas afforded yields of around 6 to 7%. In those days one purchased utility stocks along with even higher yielding industrial issues because they provided a better income than bonds. Of course everybody hoped that their stocks would "go up some day", but value and stability were of great concern in the late 1940's and early '50's.

It is easy to see how the philosophy of values has changed. Today one witnesses the spectacle of millions of small investors trying "to make a buck in the market," or "taking a flyer on a stock they told me was going up". Greed and impatience have replaced the philosophy of investing in values. Twenty-three years ago Robert Rhea wrote: "I have always regarded 'investing' in stocks to mean acquiring equities of sound value in times of depression and holding for both dividends and appreciation until prices have exceeded a line of reasonable value before selling." That statement, I might add, came from the foremost technician of his day.

The neophyte of today faces a problem which does not necessarily confront the seasoned investor. Many of my readers have sold stocks on which satisfactory long-term profits have been garnered. They know the difficulties which face the "in-and-out" trader, and they are waiting patiently for the next true opportunity to buy "values". Meanwhile, they follow the market with the interest of any veteran student.

But the neophyte wants to get his "cut of the melon" or perhaps win back some of his losses, and in attempting to make up for lost time he will take his fling at the "in-and-out" trading game. Dow's Theory concerns itself with time-tested techniques of investing, and it does not promise anyone a sure-fire method of "beating the market".

One of the incredible phenomenons of this business is the normally conservative businessman or worker who will stay awake nights pondering the pros and cons of a new inventory commitment or a new heater for his home. But when it comes to stocks he will slap down a year's earnings after taxes on an unknown stock in an uncertain market. This type of fellow is looking for something for nothing, and he willingly goes against odds that he would not even sniff at in his own business. But that, as they say, is what makes markets.

QUESTION "Is divergence (the Rail and Industrial Averages moving in opposite directions) always a sign of danger?"

ANSWER Not necessarily - often during a decline the first sign of a reversal to the upside is divergence by one Average (suggesting that the dissenting Average is resisting further decline). By the same token, divergence on a high volume advance often is a hint that the advance is nearing an end (the suggestion is that one Average is resisting further advance).

Rhea studied all instances of divergence over a thirty year period and concluded that there was no exact formula for classifying divergences. However, he believed that two or more days of divergence on high volume was a danger signal worth watching, and that such action often preceded violent reversals. Rhea also noted that in areas of extremely low volume, divergences (1) were rather common and (2) were likely to be meaningless.

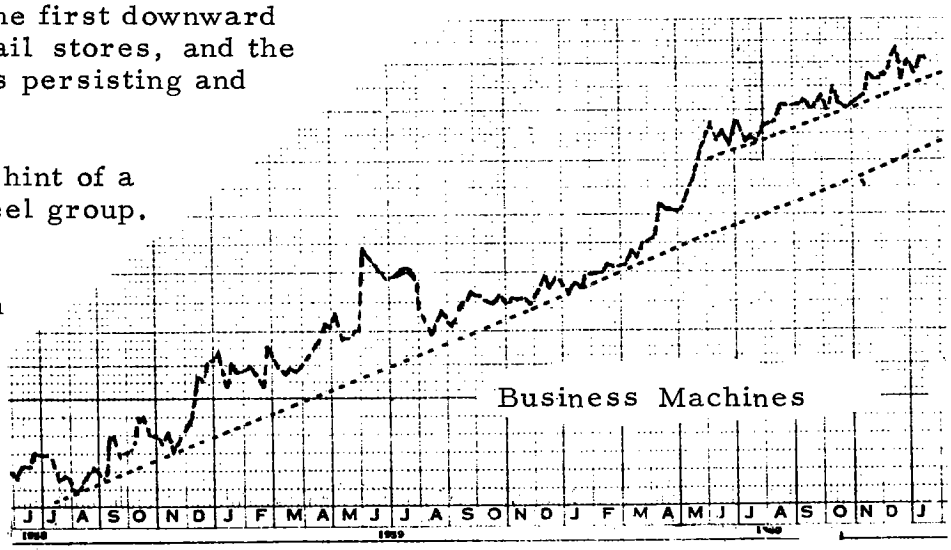
RELATIVE STRENGTH One of the most valuable of stock market studies is the relative strength (as compared with the general market) of various stock groups. It is a characteristic of relative strength that once a trend is established that trend is apt to persist for many months (occasionally as long as one or two years).

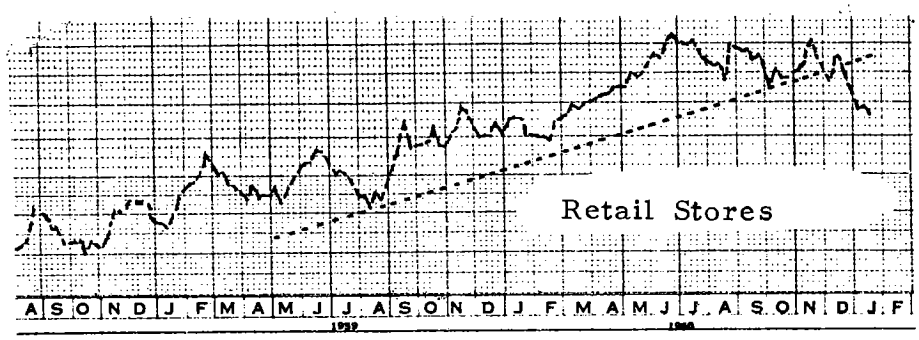
In Letter 99 (April 1, 1960) I included a chart showing the superior relative strength of the business machine group. As seen below, the trend of that group continues to outperform the market. Recently a secondary trendline has been established in business machines, and this newer trendline has formed above the major trendline. A downward penetration of the secondary line would be the first hint of weakness in this group. Confirmation of a turn in business machines would come if both trendlines were violated.

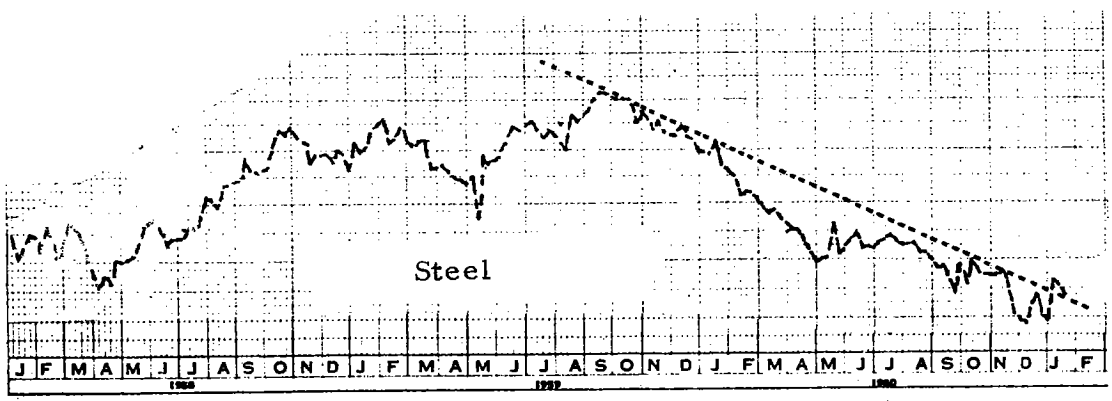
Letter 122 (November 3) showed the first downward penetration of the trendline in retail stores, and the current chart shows that weakness persisting and increasing.

The third chart provides the first hint of a turn in relative strength in the steel group. So far, the almost imperceptible January penetration of the steel trendline has not displayed enough "follow through" to be considered a reversal, but a further rise in steel relative strength would reverse a downtrend which has lasted since Setpember, 1959. (all of these charts are based on relative strength of the individual groups as compared with Standard & Poor's "500" Average).

(Written Thursday, February 2 3 P.M.)




Relative strength charts courtesy of: Traders Research, P. O. Box 6185, Lambert Airport, Missouri